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Creating Synthetic Basis Positions with SRWI Futures

Grain merchandisers often use their intimate knowledge of cash-futures relationships to profit from basis trading. However, the size of the basis position may be limited by the firm's ability to source and merchandise large quantities of grain. In these instances, traders can use the Soft Red Winter Wheat (SRWI) futures to create a synthetic basis position.

The SRWI represents a national average country-level price for #2 Soft Red Winter Wheat. Therefore, the spread between the SRWI and the CBOT futures is effectively a national average basis. A synthetic short basis position is created through the sale of the SRWI and purchase of the CBOT futures. Conversely, a long synthetic basis position is equivalent to a long SRWI position coupled with a short CBOT futures position.

As a recent example, consider a merchandiser who wants to establish a long basis position during planting time in October 2009. However, he was unable to enter into as many local forward cash contracts as he desired. The merchandiser could supplement his long basis positions for the July 2010 harvest by purchasing the June SRWI futures and selling the July CBOT wheat futures.

Table 1 shows the historical spread (basis) between the spot SRWI and the July Chicago wheat futures at the end of June from the years 1999 through 2009. This is the historical data that would be available to a merchant in the fall of 2009 when examining the spread between the June 2010 SRWI and July 2010 CBOT wheat contracts.

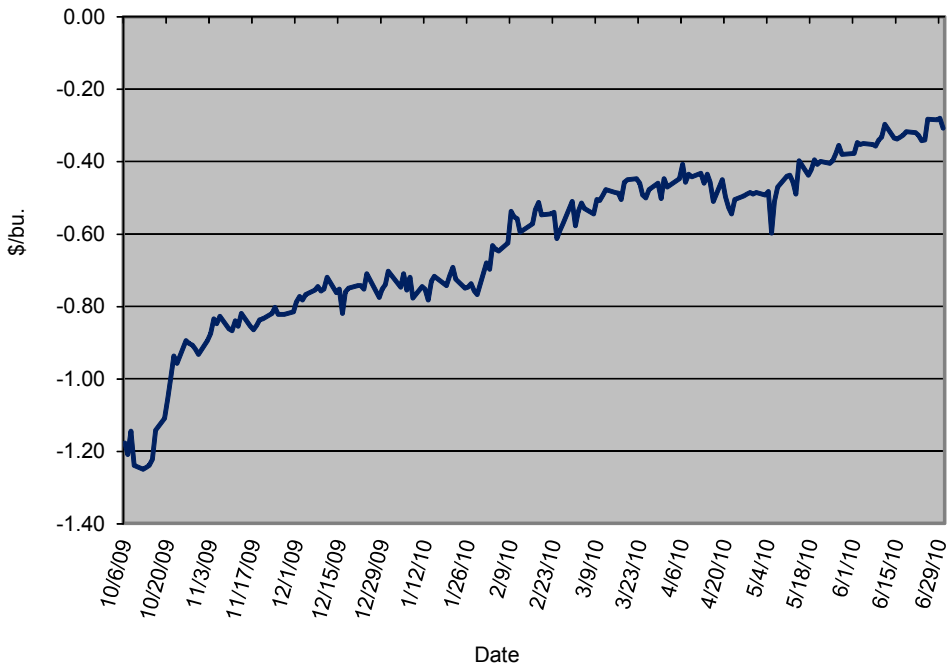
Table 1. SRWI – July Chicago Wheat Futures Spread, End of June, 1999-2009.

Year	Spot SRWI	Chicago Futures	Spread
1999	212.99	250.00	-37.01
2000	219.25	259.50	-40.25
2001	216.56	246.75	-30.19
2002	287.12	307.00	-19.88
2003	284.87	301.75	-16.88
2004	321.63	338.00	-16.37
2005	305.21	321.50	-16.29
2006	320.25	371.50	-51.25
2007	514.35	582.00	-67.65
2008	650.69	846.00	-195.31
2009	411.63	511.25	-99.62
Average			**-53.70**
Median			**-37.01**

The average (mean) and median (middle value) at the bottom of Table 1 includes all of the years from 1999 through 2009. The nearly 17 cent difference between the average and median suggests that the data may contain an outlier. The suspected outlier is clearly 2008 when wheat prices were setting all-time highs. The median is one way to account for outliers. The other way is to eliminate 2008 from the data table. Without 2008, the average increases to -39.54 which is very close to the median value of -37.01 for all years. Based on this historical data, a merchant might expect the June SRWI-July CBOT wheat spread to be in the -35.0 to -40.0 range at the end of June.

As shown in Figure 1, the June 2010 SRWI futures were trading 120 cents under (-1.20 $/bu.) the July 2010 Chicago futures in early October, 2009. A merchandiser might reasonably expect that spread to strengthen to a more normal historical relationship of -35.0 to -40.0 as shown in Table 1. The merchandiser may choose to effectively increase his long basis position by purchasing the June SRWI futures and selling the July CBOT wheat futures with the idea the spread will strengthen as the June SRWI expiration approaches.

Figure 1. June 2010 SRWI Futures – July 2010 Chicago Wheat (Synthetic Basis)



In 2010, the trade worked as expected with the June SRWI futures steadily gaining on the July CBOT soft wheat futures through the growing season. The synthetic basis strengthened from roughly -120 cents to approximately -35 cents by the end of June, when the SRWI futures financially settled. The merchandiser would have made a profit of 85 cents per bushel to supplement the income from the long basis positions he established in their cash business.

The SRWI futures allow traders to take synthetic basis positions by spreading the SRWI futures versus the CBOT soft wheat futures. With knowledge of the cash markets, merchandisers can use these synthetic basis positions to supplement or manage overall basis exposure.

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